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Chinese incorporation for institutional arbitrage and access to finance

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Emerging markets and tax havens and offshore financial centres

Comparatively little theoretical or empirical consideration has been given to the most prominent destination of emerging market outward foreign direct investment (OFDI), namely tax havens and offshore financial centres (THOFCs) and the role they play in the global economy. Brazil, Russia, India and China, all record very significant FDI to such destinations. By 2007, one half of Brazil's OFDI stock was located in just three havens and by 2009, two thirds of Russia's FDI stock was found in four havens. In 2008 and 2009, 40% of Indian OFDI flows went to two havens. The majority of Chinese OFDI is destined for several specific THOFCs. These constituencies accounted for 69–87% of the annual outflow between 2003 and 2011 so that the stock of Chinese investments in these locations now stands at around 80% of the total. In 2006, one tax haven alone, the Cayman Islands, had become the largest recipient of Chinese OFDI, with 44% of officially recognised flows (and 18% of its global OFDI stock). Subsequently, the THOFC Hong Kong became the lead recipient ahead of the Cayman Islands and British Virgin Islands (BVI). As such, the triad of the Cayman Islands, BVI and Hong Kong are very important to understanding the characteristics, motivations and behaviour of emerging market MNEs. How we account for investment flows through tax havens is important for a more complete understanding of emerging market FDI because, by comparison, the share of FDI stock for developed market economies in tax havens stood at around 25% to 33%. It is often suggested that tax-induced regulatory arbitrage is the main driver for investments in THOFCs and FDI into those countries doesn't constitute a productive activity. The notion that THOFCs are 'fictitious spaces', however, does not explain the geographic concentration of FDI in specific THOFCs, or why the average national OFDI shares to these jurisdictions are higher for many large emerging economies than for developed economies. Our intention is therefore to explore some of the reasons, moving beyond taxation related reasons alone, for the use of THOFCs. It is therefore of interest which offshore jurisdictions Chinese firms use to (i) access capital and (ii) to avail of a favourable institutional environment, including the legal institutional and regulatory environment conducive to doing business.

We argue that locality and its specificities do matter, are location bound, and difficult to transfer. THOFCs can provide 'location advantages' in terms of the institutional, legal and social relationship setting of a source country (China), the proximate host countries (BVI and Cayman Islands) and the target countries, which include China (for 'round-tripping') or the USA (for capital augmentation) as well as the eventual final destination of the capital. The taxation and legal institutions of all the relevant locations are part of an integrated global value chains, centred on an individual MNE but also embedded in all the countries in which it has have activities.

The IFC tax regime attracts businesses

An important historic explanation for the use of THOFCs has been the preferential tax rates afforded to foreign invested enterprises in China which can lead to 'round-tripping', a form of tax-induced regulatory arbitrage that involves moving capital offshore only to bring back onshore again in the guise of FDI, so as to benefit from preferential tax treatment. A variety of measures, however, have been introduced to restrict the registration of offshore holding companies by Chinese firms and

discourage round-tripping. Since January 2008 the new Enterprise Income Tax Law has harmonised tax rates for foreign invested enterprises and Chinese businesses. This provides that enterprises established under the laws of foreign countries or regions but whose 'de facto management body' is located in the PRC be treated as a resident enterprise for PRC taxation purposes. As such the tax benefits of setting up offshore holding companies have been eliminated and replaced with disincentives.

If round-tripping for lower taxes was the primary explanation for the use of THOFs, we might expect to see a reduction in their use, but this is not the case. Chinese businesses appear to use offshore companies for non-tax related purposes as well.

Augmenting capital through IFCs

Emerging market businesses are often forced to undertake a wide variety of innovative responses in an attempt to mitigate high transactions costs. In emerging markets financial systems are considered to be quite inefficient and their capital markets are imperfect. The capital markets of the People's Republic of China, for example, are generally considered not to be driven purely by market forces. State Owned Enterprises, and especially 'national champion' business groups, have privileged access to capital through the state banking sector at favourable rates and preferential access to capital markets owing to their embedded nature within the Communist Party system. Private firms, by comparison, generally face acute challenges in securing bank loans because of state control over lending within Chinese banks and control over domestic stock markets. Consequently, except for the favoured few, private firms are often crowded out of the domestic capital market. As access to domestic capital is limited by regulation, discrimination by lenders and by the restricted range of outside funders, private firms search for alternative ways to augment their capital stock, sometimes outside of China. Accessing international capital markets, particularly through international listings, is an increasingly popular alternative for Chinese businesses.

The most successful THOFs, by contrast, are recognised for their well-developed legal and financial systems, particularly those havens that also act as offshore financial centres (OFCs). The drive for offshore incorporation and FDI flows may, therefore, be driven not only by domestic capital market imperfections and the needs of EM MNEs to augment their existing capital structure, but also by access to a more favourable institutional environment. Outward investors seek locations that minimise the cost of their activities so as to achieve optimality in location for the firm. Registering as a company in a tax haven could enable Chinese companies to circumvent imperfections in the domestic Chinese capital market. In other words, this may drive what has been referred to as 'institutional arbitrage', in which MNEs use THOFs to internalise institutional and market differences between countries, with the strategic intent of guaranteeing their long term economic viability. As such, firm-level financing and institutional arbitrage decisions become an important determinant of where MNEs invest.

The Cayman Islands, for example, offers zero rates of tax on income and capital gains and secrecy regulations, which are advantages that can be exploited through the use of complex transfer pricing and intra-corporate loan strategies. But it also offers firms to minimise their costs of raising capital. The Cayman Islands is the world's fifth largest financial centre by asset size and an important adjunct to the North American capital markets. The most recent comparisons show it had 464 offshore banks, compared with nine in the BVI, 30 in Cyprus and 77 in Guernsey. As an OFC it also specialises in business related cross-border financial services, particularly in banking. It held total banking assets of US\$1.7 trillion in 2009 and has become jurisdiction to 75% of the world's hedge funds and nearly

half of the estimated US\$1 trillion assets under management. Most importantly of all, however, by vertically locating a listing vehicle within the Cayman Islands, IPOs may be undertaken on multiple stock exchanges, including both Hong Kong and US stock exchanges. Historically, no other havens have provided this facility. Thus, the Cayman Islands is the jurisdiction of choice for listing vehicles and raising capital. As such, finance, accounting and legal professionals argue that the use of a Cayman vehicle is not wholly or mainly for tax planning purposes. This is not, of course, to say zero tax rates are unimportant, but simply that many other jurisdictions also offer such incentives.

In our research on the usage of THOFCs by Chinese firms, we found that 72 firms raised estimated gross IPO proceeds of US\$11 billion and net proceeds of US\$9.8 billion through listings in the USA. Suntech Power is a representative example, illustrating the sequence whereby Chinese businesses develop their offshore corporate structures. Suntech was originally incorporated in Wuxi (Jiangsu province), China as Suntech China. It designs, develops and manufactures a variety of photovoltaic cells and modules and is one of the world's largest producers. Suntech raised net IPO proceeds of US\$321.8mn on the New York Stock Exchange (NYSE) in 2005. Once in place, these offshore structures allow Chinese companies to raise further capital. In 2009, for example, Suntech closed a follow-on offering on the NYSE with net proceeds of US\$277 million and received through corporate bond offerings of US\$1.1 billion. Following its IPO, access to short term bank borrowing dramatically improved, its net proceeds from short-term bank borrowing increased from US\$15.3 million in 2005 to US\$305.8 million by 2008. Suntech was able to realise net proceeds of US\$294.1 million in longer term bank loans by 2009. Both Chinese and international banks lent to Suntech. The capital raised has allowed Suntech to expand its production capacity, exploit its China based low-cost manufacturing model and to allow it to undertake a series of acquisitions in industrialised countries.

Exploiting institutional differences

THOFCs may provide institutional support for the restructuring of operations back in China. The market for property rights of Chinese businesses was late in its development and the domestic transactions costs are reportedly high. OFDI to THOFCs allows Chinese firms to reduce costs arising from various types of institutional misalignments. Chinese firms, moreover, avail of administrative and professional institutions, and engage in a form of arbitrage whereby they exploit the comparatively superior institutions of foreign markets. It is notable that important transactions involving the buying and selling of Chinese businesses take place via these offshore jurisdictions. We find evidence that 22 firms have acquired fully or partially one or more other China-based companies that are themselves held through offshore holding companies, supporting the idea that havens offer a supportive institutional environment for organisational restructuring. Chinese firms may also benefit from foreign banking and financial expertise, which can add value to the Chinese capital, as well as more sophisticated and stable legal institutions. This allows businesses to undertake significant restructuring of their mainland operations via THOFCs and reduce their exposure to, and negotiation with, Chinese institutions in this process. As with the high transactions costs incurred in domestic capital markets, transactions costs in the domestic market for property rights may force businesses to seek less costly and effective alternatives. More specifically, when transactions costs are high firms investing in the havens follow strategies to reduce exposure to domestic institutional conditions.

Xinhua Sports & Entertainment Limited (XSEL) is a sports and media entertainment group that conducts all of its operations in mainland China. It has grown significantly since its inception, primarily through the acquisition of assets and businesses and development of its distribution channels. After XSEL secured access to international capital markets it has undertaken numerous acquisitions. The proceeds from the IPO were used to fully acquire at least seven privately held

offshore holding companies that own (or control) other onshore Chinese media businesses. These companies in turn effectively control at least 29 mainland Chinese subsidiaries and a further eight offshore holding companies. Through its 2007 acquisition of East Alliance Limited, a BVI holding company, XSEL controls all of East Alliance's wholly owned subsidiaries and variable interest entities collectively known as the M-Group, a mainland China-based mobile service provider.

CONCLUSION

Our findings show that Chinese MNEs invest in THOFCs in order to access capital markets and institutions that are not available to them domestically. As well as this, they also address capital market imperfections in and through particular THOFCs, taking advantage of the respective specialisations of these spaces, as well as the networks that these jurisdictions are embedded within. Even despite increased regulation and higher costs associated with offshore incorporation, Chinese MNEs continue to undertake FDI to THOFCs to address the significant domestic market imperfections they face. While many countries aspire to become tax havens it is only those with the best governance and institutions that actually succeed. Low taxes, therefore, are only one, albeit important attraction, of THOFCs. Comparatively superior capital markets and more efficient institutions for property rights are also driving Chinese OFDI to THOFCs, facilitated by multinational advanced business service providers. In this light, Pollard's (2003, 446) comment that 'finance is a fundamental part of economic co-ordination that is not logically prior to or separate from production', is highly germane. The capital raised offshore facilitates both further domestic and international expansion of Chinese businesses, illustrating its direct links to production.

METHODOLOGY BOX

Comparatively little research, owing to the inherent secrecy of havens, has been undertaken at the micro (firm)-level. This veil of secrecy makes it difficult to determine which firms have interests in THOFCs and what activities they engage in once offshore. One of the few windows through which to observe such behaviour is the publicly available data of firms that have raised capital on foreign stock markets. All businesses listed on stock markets in the USA, for example, must submit various formal documents to the US Securities Exchange Commission (SEC) (US SEC EDGAR database), including annual financial statements and reports. It is a requirement of the SEC that foreign private issuers complete a 20-F form annually. These submissions, owing to legal obligations, are generally candid in nature and provide detailed information on company accounts; capital raising activities and use of proceeds from such activities; information on the organisational structure; subsidiary information including the country in which any listing vehicle is incorporated and the use of offshore vehicles for such purposes.